# No. 7788

IN THE

# United States Circuit Court of Appeals

**For the Ninth Circuit**

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PHILIP N. LILIENTHAL,
*Petitioner,*

vs.

COMMISSIONER OF INTERNAL REVENUE,
*Respondent.*

**On Petition for Review of Decision of the United States Board of Tax Appeals.**

## BRIEF FOR PETITIONER.

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### OPINION BELOW.

The only previous opinion is the unreported memorandum opinion of the United States Board of Tax Appeals (R. 16-23).

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### JURISDICTION.

This appeal involves an alleged deficiency of $38,107.54 of income taxes for the year 1927, and is taken from a decision of the United States Board of Tax Appeals entered September 29, 1934 (R. 24). The office of the Collector of Internal Revenue, to whom petitioner made his return, is at San Francisco, Cali-

fornia, which is within the Ninth Circuit of the Circuit Court of Appeals. Petitioner is a resident of that circuit. Appellate jurisdiction is conferred upon this Court by Sections 1001-1003 of the Revenue Act of 1926.

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## QUESTION PRESENTED.

I. Does the acquisition by one corporation of a majority of the voting stock (there being no non-voting stock) of another corporation constitute a "reorganization" within the purview of Section 203 (h) (1) of the Revenue Act of 1926?

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## STATUTES AND REGULATIONS INVOLVED.

Section 203, Revenue Act of 1926:

> "Sec. 203. (a) Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 202, shall be recognized, except as hereinafter provided in this section.
>
> * * * * * * *
>
> (b) (2) No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.
>
> * * * * * * *
>
> (d) (1) If an exchange would be within the provisions of paragraph (1), (2), or (4) of subdivision (b) if it were not for the fact that the property received in exchange consists not only

of property permitted by such paragraph to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

* * * * * * *

(h) (1) The term 'reorganization' means (A) a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation), * * *

(h) (2) The term 'a party to a reorganization' * * * includes both corporations in the case of an acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation."

Treasury Regulations 69:

"Art. 1574. **Exchanges in connection with corporate reorganizations.** * * * no gain or loss shall be recognized if, in pursuance of a plan of reorganization, stock or securities in a corporation a party to a reorganization are exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization * * * If two or more corporations reorganize, for example, by— * * *

(6) The acquisition by A of a majority of the voting stock and a majority of the total number of shares of all other classes of stock of B or of substantially all of the properties of B, * * * then

no taxable income is received from the transaction by corporation A or B if the sole consideration for the transfer of the assets is stock or securities of corporation A or B; and no taxable income is received from the transaction by the shareholders of either corporation A or corporation B if the sole consideration received by the shareholders is stock or securities of corporation A or B."

"Art. 1575. **Exchanges in reorganizations for stock or securities and other property or money.** —If stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged for stock or securities in such corporation or in another corporation a party to the reorganization and other property or money, the gain, if any, to the recipient will be recognized in an amount not in excess of the sum of the money and the fair market value of the other property."

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## STATEMENT OF FACTS.

The entire evidence submitted to the Board was in the form of a stipulation of facts, which is set out in the record (R. 31-54).

In so far as necessary for a determination of the issue involved, the controlling facts may be summarized as follows:

During the year 1927 two companies existed, viz., Southern California Gas Company (hereinafter for convenience called "Old Southern") and Midway Gas Company. Midway was principally engaged in

purchasing natural gas in the oil fields and transporting and selling it to distributing companies. Old Southern was engaged in distributing natural and artificial gas to consumers and purchased the bulk of the output of Midway.

In October, 1927, an agreement was executed between a banking syndicate and the controlling stockholders of Old Southern and Midway, providing for the organization of a new corporation, which should acquire all of the capital stock of Midway and a majority of the outstanding stock of Old Southern in exchange for cash and bonds of the new corporation. The bonds were to be secured by the shares of stock of Midway and Old Southern to be acquired. As part of the plan, Old Southern was to acquire the property and business of Midway and thereafter Old Southern was to conduct the business formerly carried on both by it and Midway.

The agreement and plan of exchange were carried out as contemplated and pursuant thereto in November, 1927, Southern California Gas Corporation (hereinafter designated as New Southern) issued and delivered its bonds and cash in exchange for shares of stock of Old Southern and Midway.

Ruth H. Lilienthal, wife of petitioner, being the owner of certain shares of stock of Old Southern, exchanged such shares in November, 1927, for cash and bonds of New Southern—all pursuant to the agreement and plan referred to. Petitioner and his wife, having filed a joint income tax return for the year 1927, reported therein a profit on the exchange to the extent of the cash received, but treated the bonds of

New Southern as having been received in a non-realizing transaction, to-wit, in connection with a reorganization as defined by the taxing statute. Respondent, however, held that there had not been a statutory reorganization and accordingly increased the profit by an amount representing the excess of the fair market value of the bonds received over the cost to Mrs. Lilienthal of the shares of Old Southern which had been exchanged. This action on the part of the Commissioner gives rise to the entire deficiency.

From respondent's determination, petitioner prosecuted an appeal to the Board of Tax Appeals, where respondent's determination was affirmed. Feeling aggrieved at the decision of the Board, petitioner has brought the case to this Court for review.

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**ARGUMENT.**

If the statute and the regulations applicable to the transaction here involved can be regarded as meaning what they say, then it inevitably follows that the taxable gain upon the exchange is limited to the amount of cash received. We have here a literal compliance with the taxing statute, because:

1. A reorganization was effected by virtue of the fact that New Southern acquired a majority of the voting stock (there being but one class of stock, that is, voting stock) of Old Southern (Section 203, Revenue Act of 1926, and Article 1577, Regulations 69).

2. Both New Southern and Old Southern were parties to the reorganization by virtue of the acqui-

sition by the former of more than a majority of the voting stock of the latter (Section 203 (h) (2), Article 1577, Regulations 69).

3. Petitioner's wife exchanged stock in Old Southern for securities (bonds) in New Southern and cash, and such exchange was in pursuance of the plan of reorganization as outlined by the various agreements between the parties, which are in the record (Section 203 (b) (2) and (d) (1), Revenue Act of 1926, and Article 1574-5, Regulations 69).

The applicable provisions of the Revenue Act of 1926 had their exact counterparts in the Revenue Acts of 1921 and 1924, and continuous administrative construction has given to these provisions the meaning contended for herein. Article 1566 of Regulations 62 (1921 Act); Articles 1574 and 1577 of Regulations 65 (1924 Act). As a matter of fact, even up to the present time, the Treasury Department has not amended or changed its regulations appertaining to the Revenue Acts of 1921, 1924 or 1926, in so far as the subject matter here involved is concerned. From 1921 to 1933, it was uniformly regarded by taxpayers and the Treasury Department alike that a reorganization within the meaning of the taxing statute, was effected when there had been compliance with the words of the statute, viz., the acquisition by one corporation of a majority of the voting stock and a majority of all other classes of stock of another corporation.

Despite the clear and unambiguous language of the taxing statute and the settled administrative construction which, if followed, should have compelled a

decision in favor of petitioner by the Board of Tax Appeals, the Board rendered its decision in favor of respondent. In so doing the Board relied entirely upon a patently erroneous interpretation of the taxing statute—an interpretation placed upon the statute by the Board itself in two decisions rendered in the year 1933. (*Watts v. Commissioner,* 28 B. T. A. 1056, and *Minnesota Tea Company v. Commissioner,* 28 B. T. A. 591). However, this new interpretation of the taxing statute by the Board was flatly rejected by the Circuit Court of Appeals for the Second and Eighth Circuits, where the decisions of the Board in the *Watts* and *Minnesota Tea* cases were reversed. *Such reversals were handed down subsequent to the decision of the Board in the instant case.*

In the *Watts* and *Minnesota Tea* cases the Board held that the acquisition by one corporation of a majority of the voting stock and of all other classes of stock of another corporation or the acquisition by one corporation of substantially all of the properties of another corporation did not *per se* constitute a "reorganization" within the meaning of the taxing statute. The Board held that the transaction must

> "be part of a strict merger or consolidation or of something which partakes of the nature of a merger or consolidation and has a real semblance to a merger or consolidation and involves a continuance of essentially the same interests through a modified corporate structure."
>
> *Minnesota Tea Co. v. Commissioner,* supra.

Speaking specifically, the Board of Tax Appeals in the cases alluded to above, held that in addition to

compliance with the provisions of the statute, there must be (1) a dissolution of the corporation whose assets or shares of stock have been acquired by a second corporation, and (2) there must be a continuity of stockholders' interest from the old corporation into the new.

In *Rippell & Co. v. Commissioner*, 30 B. T. A., page 1146, the identical facts and issue presented here were involved, namely, the question as to whether the acquisition by New Southern of a majority of the stock of Old Southern constituted a reorganization. In holding that such acquisition did not constitute a reorganization, the Board relied solely upon its decisions in the *Watts* and *Minnesota Tea* cases, stating:

> "What occurred in this case was in fact merely a change in the ownership of a majority of the voting capital stock of the Gas Co. A partial or even complete change of stock ownership does not constitute a statutory reorganization. There was no transfer of assets, followed by a continuity of interest under a new or modified corporate structure; nor was there a merger or consolidation, or anything in the nature thereof, which effected such continuity of interest through an exchange of stock for stock. * * *
>
> In the case at bar there was no continuity of stockholders' interests from the old corporation into the new; there was no change in the form of corporate ownership through which the interests of the old stockholders were continued in the same property. The new corporation merely purchased for cash and bonds approximately 60 per cent of the voting stock of the old corpora-

> tion, which latter company 'continued its corporate existence and operations in exactly the same manner as prior thereto, unaffected and without modification in any way as a result of the change in the ownership of its common capital stock.'
>
> If the old corporation had exchanged all of its assets for stock of the new corporation, and if the old corporation had thereupon distributed the stock so received among its stockholders in liquidation, the transaction would have amounted to a reorganization, within the meaning of the statute. Cf. Minnesota Tea Co., 28 B. T. A. 591, 596. But this was not done. A wholly different situation is presented, which in our opinion falls short of constituting a statutory reorganization."

In rendering its decision in the instant case, the Board simply cited its decision in *Rippell v. Commissioner,* supra.

That the Board of Tax Appeals was in error in attempting to read into the taxing statute something which did not exist is demonstrated not only by the long standing prior administrative and judicial construction of the statute, but also by the fact that the Circuit Court of Appeals for the Second and Eighth Circuits, respectively, reversed the decisions of the Board in the *Watts* and *Minnesota Tea* cases in the early part of this year. *However, as pointed out above, at the time of the rendition of the opinions of the Board, both in the Rippell case and in the instant case, neither of the decisions of the Circuit Court in the Watts or Minnesota Tea cases had been handed down.*

In *Watts v. Commissioner,* 75 Fed. (2d) 981 (C. C. A. 2), the facts were as follows: Three persons owning all of the stock of Alloys exchanged their stock for stock of Vanadium and for mortgage bonds of Alloys, which were guaranteed by Vanadium. Alloys continued in business for a number of years after the exchange in the same manner as it had done in the past and the Board of Tax Appeals held that since there was no dissolution of Alloys, the transaction did not partake of the nature of a merger or consolidation, and therefore no reorganization existed. In reversing the Board, the Circuit Court of Appeals said:

> "Sec. 203 (b) (2) of the Revenue Act of 1924 provided that: 'No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.'
>
> And Sec. 203 (h) of the same statute provided so far as here applicable that:
>
> '(1) The term "reorganization" means (A) a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, * * *).'
>
> Art. 1574 of T. R. 65, in so far as pertinent to the present problem, provided that under the law above noted '* * * no gain or loss shall be recognized to the shareholders from the exchange of stock made in connection with the reorganization * * *. If two or more corporations reorganize, for example, by either * * *

(3) the sale of the stock of B to A, or * * * (6) the acquisition by A of a majority of the total number of shares of all other classes of stock of B. * * *'

Since the transaction here involved is one that verbally falls within the concept of 'reorganization' as shown by the regulation (as all of the stock of Alloys went to Vanadium, either subdivision (3) or (6) covers the transaction) the real issue is simply whether the regulation has unlawfully broadened the statutory definition of 'reorganization'. The plan of reorganization was the contract made and performed.

In the above statute it will be seen that reorganization was defined to be a merger or consolidation, with those terms somewhat expanded by matter in parentheses 'so as to include some things which partake of the nature of a merger or consolidation but are beyond the ordinary and commonly accepted meaning of those words—so as to embrace circumstances difficult to delimit but which in strictness cannot be designated as either merger or consolidation.' *Pinellas Ice & Cold Storage v. Commissioner,* 287 U. S. 462, 470. In *Cortland Specialty Co. v. Commissioner,* 60 Fed. (2) 937, we had before us the taxable effect under the similar Sec. 203 (h) (1) of the Revenue Act of 1926 of a sale of the assets of a corporation for cash and short term notes and held that the gain from the transaction was not tax free. In that connection we discussed merger and consolidation generally in their relation to a reorganization within the meaning of the statute but the facts there did not present the issue now before us. And in *C. H. Mead Coal Co. v. Commissioner,* 72 Fed. (2) 22, while the precise question here was not involved, the necessity for giv-

ing a liberal scope to the words 'merger' and 'consolidation' as used in the statute, which, as already noticed, was in respects now essential like the statute controlling here, was recognized.

We think the legislative history of the statute requires its interpretation in a way which shows that the Board in this instance was in error in sustaining the deficiencies. It was divided in opinion, with the majority taking the view that there was no 'reorganization' while there was no dissolution of Alloys.

In the Revenue Act of 1918, Congress for the first time dealt with the effect of reorganization upon taxation and provided in Sec. 202 (b) that '* * * when in connection with the reorganization, merger, or consolidation of a corporation a person receives in place of stock or securities owned by him new stock or securities of no greater aggregate par or face value, no gain or loss shall be deemed to occur from the exchange * * *.'

The terms 'reorganization', 'merger', and 'consolidation' were left without especial definition for the purposes of the statute, and the Treasury Department promulgated Regulations 45, which required in such a situation as that before us the dissolution of the corporation whose stock was acquired by another corporation as a condition precedent to sustaining the claim of freedom from taxation which the petitioners make. In 1921, however, Congress saw fit to change the statute and then included in Sec. 202 (c) (2) of the 1921 Act the same statutory definition of reorganization which was carried into the 1924 Act and is effective here. The term 'reorganization' was the subject of some controversy between the House and the Senate but this was resolved

as is shown by the report of the Conference Committee which stated:

> 'The Senate amendment adds to this definition the case where one corporation acquires at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation; * * *; and the House recedes.' Conf. Rep. No. 486, 67th Congress 1st Session, p. 17 and 18.

After the 1921 Act went into effect the Treasury Department promulgated regulations which differed from those under the 1918 Act. The language found both in subdivision (3) and in (6) of T. R. 65; Art. 1574, above quoted, was used to define a reorganization. T. R. 62; Art. 1566 (b). It will thus be seen that the regulations no longer required a dissolution of the corporation whose stock was acquired in order to entitle persons in the situation of these petitioners to make such an exchange on a tax-free basis.

In 1924 Congress enacted the statute under which these deficiencies were assessed, and then had under consideration whether Art. 1566 of T. R. 62, in providing that in the case of a reorganization no gain or loss should be recognized to the corporations as well as to the stockholders, had, in putting the corporations in a reorganization on the same basis with stockholders, gone beyond the scope of the 1921 Act. It was proposed to resolve this difficulty by changing the statute so as to eliminate all doubt about the validity of the regulations in this respect. The Senate Committee reported on the subject that:

> 'There is no corresponding provision of the existing law, although this paragraph embodies

the construction placed by the Treasury Department upon the existing law. The present ruling of the Treasury Department is of doubtful legality and a statutory provision is most necessary.' Sen. Rep. No. 398, 68th Congress, 1st Session, p. 14 and 15.

This proposed change was made. Nevertheless, the definition of reorganization as it had been in Sec. 202 (c) of the 1921 Act was reenacted without material change in Sec. 203 (h) (1) in the 1924 Act. Under well established principles of construction, this reenactment of the definition of reorganization after it had been interpreted by regulation is strong evidence that Congress intended Sec. 203 (h) (1) to include within the meaning of the word as there defined such an exchange of stock for stock and bonds as these petitioners made. *Zellerbach Paper Co. v. Helvering,* 293 U. S. 172; *United States v. Dakota-Montana Oil Co.,* 288 U. S. 459; *Norwegian Nitrogen Co. v. United States,* 288 U. S. 294; *Constanzo v. Tillinghast,* 287 U. S. 341; *McCaughn v. Hershey Chocolate Co.,* 283 U. S. 488; *Shearman v. Commissioner,* 66 Fed. (2) 256. In our opinion, therefore, subdivisions (3) and (6) of Art. 1574 of T. R. 65 are valid and either makes it impossible to affirm the decision of the Board of Tax Appeals sustaining the deficiencies determined in the case of each of these petitioners. Having had the opportunity, it is to be presumed that if Congress had intended, contrary to the regulation in force, to have the gain from such an exchange as this be tax free only when there was a dissolution of one of the corporations or some other change in the corporate structure such as would commonly take place in a merger or consolidation, strictly speaking, it would have

> said so. The fact that it changed a related part of the statute to remove any doubt as to the validity of a regulation and at the same time reenacted the part which had been construed by the regulation which governs here shows an adoption of such construction. *National Lead Co. v. United States,* 252 U. S. 140; *United States v. Cerecedo Hermanos y Compania,* 209 U. S. 337; *Francisco Sugar Co. v. Commissioner,* 47 Fed. (2) 555."

The *Watts* case specifically holds that where a corporation acquires at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, a "reorganization" has been effected within the meaning of the taxing statute and each of the corporations is "a party to a reorganization".

Such a holding fits the exact facts of the instant case and is determinative of the issue involved herein.

Cf. also *Minnesota Tea Co. v. Commissioner,* 76 Fed. (2d) 797 (C. C. A. 8), where it was held that the acquisition by one corporation of substantially all of the properties of another corporation constituted a "reorganization" within the purview of Section 203 (h) (1) of the Revenue Act of 1926. In reversing the decision of the Board of Tax Appeals, the Circuit Court of Appeals in the *Minnesota Tea Co.* case pointed out that the Courts may not read into a statute additional conditions not therein expressed; that neither dissolution nor a continuance of the same actual ownership of substantially the same properties was required to effect a reorganization under the taxing statute; that long settled ad-

ministrative construction given to the reorganization provisions by the Treasury Department could not be lightly ignored and that it is to be presumed that Congress in reenacting the reorganization provisions of the 1921 Act in the 1924 and 1926 Revenue Acts, had in mind the construction placed upon the prior statutes. As further authority for its conclusion, the Circuit Court of Appeals relied upon the decision of the Second Circuit in *Watts v. Commissioner,* supra.

In fairness to respondent, it should be pointed out that he has docketed in the Supreme Court a petition for a writ of certiorari in each of the two cases alluded to, viz., the *Watts* and *Minnesota Tea* cases. The Supreme Court has not as yet acted upon either of the petitions. If certiorari should be granted, the decision of the Supreme Court in those cases would effectively dispose of the issue herein, and if certiorari be denied, then this Court should follow the promulgated regulations and unbroken line of decisions of Circuit Courts of Appeals in other jurisdictions and reverse the judgment of deficiency rendered against petitioner herein.

Dated, San Francisco,
September 27, 1935.

Respectfully submitted,
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